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ADI - Q3 2015 Analog Devices Inc Earnings Call

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OVERVIEW:

Co. reported 3Q15 revenue of $863m and diluted EPS, excluding special items, of $0.77. Expects 4Q15 revenue to be $880-940m and diluted EPS, excluding special items, to be $0.79-0.87.

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PRESENTATION

Operator

Good afternoon. My name is Jennifer and I will be your conference facilitator. At this time, I would like to welcome everyone to Analog Devices' third-quarter FY15 earnings conference call. All lines have been placed on mute to prevent any background noise. After the opening remarks, there will be a question-and-answer period.

(Operator Instructions)

I would now like to turn the conference over to your host for today, Mr. Ali Husain, Director of Investor Relations. Please proceed.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Thank you, Jennifer, and good afternoon, everyone. Thank you for joining Analog Devices' third-quarter FY15 earnings conference call. You can find our press release and relating financial schedules in our investor page at Investor. Analog.com. Before we begin, I want to call your attention to two new items. Number one is about a change around the timing of our future earnings conference calls, and number two is about increasing the level of information we provide investors. So first, starting next quarter, which will be our fiscal fourth quarter, we are going to move our earnings conference call to the morning. After speaking with many investors and analysts, we believe a morning call is a more convenient time for all stakeholders. As a result of this change, starting November 24, 2015, which is our fourth-quarter 2015 earnings call, and for every quarterly earnings conference call thereafter, we will issue our earnings release at 8 AM Eastern time, and the earnings conference call will take place two hours later at 10 AM Eastern time. Secondly, we have introduced an investor slide deck, which we call the investor toolkit, and this slide deck or toolkit has been designed to provide investors with even more clarity around our results. We've posted the toolkit on our investor page at investor.analog.com, and this is something we plan to prepare and post every quarter to our website. So let's get back to today's call.

As usual, I'm joined by ADI CEO Vincent Roche and ADI CFO Dave Zinsner. Our agenda for today's call will be as follows: first, I will provide a brief overview of our third-quarter results, then Dave will review our financial performance in the third quarter and provide our business outlook for the fourth quarter. And finally, Vince will capstone the scripted portion of today's call with his closing remarks. Now as is customary, after our prepared remarks, we'll open up the lines for Q&A. So please note the information we are about to discuss today, including our objectives and outlook, includes forward-looking statements. Actual results may differ materially from these forward-looking statements as a result of various factors, including those discussed in our earnings release and our most recent 10-Q. These forward-looking statements reflect our opinion as of the date of this call and we undertake no obligation to update these forward-looking statements in light of new information or future events. Our comments today will also include non-GAAP financial measures, which we have reconciled to their most directly comparable GAAP financial measures in today's earnings release, which we've posted on our IR page at Investor. Analog.com. So with all that behind us, let's get started.

So as you've likely seen from our press release, ADI had another very strong performance in the third quarter of 2015. The combined power of our franchise, our commitment to innovation, the diversity of our business, and our continued strong execution delivered results that were at very high end of our guidance range. Revenue in the third quarter of $863 million increased 5% sequentially and 19% year over year, once again establishing a new high watermark for ADI. By end market, the industrial and automotive sectors were about in line with our expectations, while consumer revenue exceeded our plan and more than offset the impact from a weak wireless infrastructure CapEx environment.

Now I'd like to give you some color on our performance by end market during the third quarter. At 44% of total sales, our highly diversified industrial business was about even to the prior quarter. Strength within industrial verticals such as aerospace and defense, and the renewable energy sector was offset by weaker industrial automation sales. End-customer bookings in the industrial market were generally stable during the quarter. We believe that there is currently a good match between supply and demand in our industrial business, which is largely serviced through distribution where we recognize revenue in all regions of the world on a sell-through basis.

Now turning to automotive, after growing 13% sequentially in the second quarter, automotive decreased 7% in the seasonally slower third quarter and represented 15% of our total sales. At the current quarterly run rate, automotive represents a $500-million plus annual business for Analog Devices.

Revenue from our hundreds of communications infrastructure customers at 16% of sales declined 22% sequentially, which was the third consecutive quarter of sequential revenue declines in this sector. Revenue from wire-line customers represented about one-third of our communications infrastructure sales and was approximately flat to the prior quarter. A weaker-than-planned wireless infrastructure market in North America and China, combined with customer inventory draw downs impacted our performance in the third quarter. We believe that current wireless infrastructure revenue run rates for ADI are artificially low, and that our strong position in the sector will allow us to recover rapidly when this market snaps back, as it usually does without much notice.

Consumer revenues at 24% of sales grew significantly over the prior quarter. While prosumer audio/video was stable sequentially, portable applications continued to drive our consumer growth. Our strategy in consumer remains strikingly consistent. We participate in those applications where we can leverage existing core technology to solve our customers toughest challenges, where we believe our innovation is sustainable and where our technology makes a meaningful difference to the user experience, and by leveraging existing core technology, we further increase the ROI on our R&D investments.

So now I'd like to turn the call over to Dave for details of our financial performance in the third quarter. With the exception of revenue and other expense, Dave's comments on third-quarter 2015 P&L line items will exclude special items, which in the aggregate totaled $30 million. When comparing our third-quarter performance to our historical performance, special items are also excluded from prior-quarter results and year-over-year results, and reconciliations of these non-GAAP measures to their comparable GAAP measures are included on Schedule E in today's earnings release. So with that, Dave, it's all yours.

Dave Zinsner - *Analog Devices, Inc. - CFO*

Thank you, Ali, and good afternoon, everyone. The third quarter of 2015 turned out to be another strong quarter for ADI, with revenue increasing to a record $863 million and diluted earnings per share of $0.77, both at the high end of the range. Gross margin in the third quarter of 66.1% was down 40 basis points from the prior quarter and was well within our gross margin model range of 65% to 68%. Factory utilization in the third quarter was about even to the prior quarter. Inventory on a days basis in the third quarter increased by one day to 128 days, and on a dollars basis, increased by $30 million, primarily related to the positioning of inventory for higher expected consumer revenue in the fourth quarter. Deferred revenue on shipments to distributors on a dollars basis increased by 6% from the prior quarter, and distributor inventory on a weeks basis was at 7.5 weeks, which is within our model range and consistent with the prior quarter.

Operating expenses in the third quarter increased 2% sequentially, lagging well behind the 5% sequential increase in revenue as we continue to manage operating costs very tightly, allowing us to gain more operating leverage in our model. As a percent of sales, operating expenses in the third quarter declined 90 basis points compared to the prior quarter and declined 210 basis points compared to the same period a year ago. Operating profit as a percent of sales has been on a steady march upward, starting in the first quarter of 2014, when it was 29% of sales. In the just-completed quarter, operating profit was approximately 500 basis points higher, at 34.2% of sales, increasing sequentially and year over year, and well within our operating model range of 32% to 36% of revenue.

Other expense in the third quarter was approximately $6 million. We expect our net interest expense to be approximately $5 million in the fourth quarter. Our third-quarter tax rate was approximately 15%, which is also the rate we expect in the fourth quarter. Excluding special items, diluted earnings per share of $0.77 increased by 5% over the prior quarter and 22% year over year, and was at the high end of our guidance range. At the end of the third quarter, our cash and short-term investment balance was $3.1 billion, with approximately $700 million available domestically. We had approximately $870 million in debt outstanding, which resulted in a net cash position of $2.2 billion. During the third quarter, capital expenditures were $35 million. Our capital expenditure plan for FY15 is to be between $155 million and $160 million.

Our financial model generates strong cash flows, and we are committed to returning cash to our shareholders. For the trailing 12 months, we generated free cash flow of $822 million, or 25% of sales, and returned $784 million, or 95% of that free cash flow, to shareholders in the form of dividends and share repurchases. Today we announced that our Board of Directors declared a cash dividend of $0.40 per outstanding share of common stock, and that will be paid on September 9th to all shareholders of record at the close of business on August 28th. So in summary, the third quarter was another very successful quarter for Analog Devices.

So now I'll turn to our fourth-quarter outlook, which with the exception of revenue, is on a non-GAAP basis and excludes special items that are outlined in today's call and release. While order trends in the industrial market are stable, we are entering the seasonally slower fourth quarter for our industrial business, and as a result, expect this sector to decline somewhat from the third-quarter levels. In automotive and communications infrastructure, order rates are also stable, and we've therefore expect these markets to remain about even to the third-quarter levels. In consumer, we expect to benefit from strong seasonal and cyclical trends, leading us to plan for continued strong revenue growth in the fourth-quarter. So in total, we're planning for revenue in the fourth quarter to be in the range of $880 million to $940 million, which represents an increase of approximately 2% to 9% sequentially. At the midpoint of this range, revenue of $910 million would represent an increase of 12% year over year. We expect gross margins in the fourth quarter to be approximately 65.5% given the likely mix of business. We are anticipating operating expenses in the fourth quarter to increase between 1% and 3% sequentially, lagging our expected sequential revenue growth in the fourth quarter.

One line item that we expect to exclude from our fourth-quarter non-GAAP operating expenses is a special charge of approximately $220 million associated with the conversion of our Irish defined benefit plan to a defined contribution plan. This conversion will give people employed by ADI's operations in Ireland more ownership in their own retirement assets and will benefit the Company by eliminating a growing long-term liability, while reducing expense volatility that is typically associated with these defined benefits plans. Based on these estimates and excluding this and other special items, diluted earnings per share is anticipated to be in the range of $0.79 to $0.87 in the fourth quarter. At the midpoint of this range, diluted earnings per share is expected to grow 20% year over year, which would be a great result relative to our EPS model of 8% to 15% growth. So now I'll turn the call over to Vince closing remarks.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you, Dave, and good afternoon, everybody. As we've talked about in today's remarks, the third quarter was another excellent quarter for ADI, reflecting the combined power of our strong execution and our balanced approach to growth, profitability, and shareholder returns. At ADI, we continue to focus on superior and sustainable innovation, and we leverage our investments across diverse applications and customers. Today, ADI's 20,000 strong product offerings are in thousands of applications at over 100,000 customers, helping them sense, measure, interpret, and connect the physical world. It is quite true to say that wherever the toughest signal processing challenges lie, be they on a factory floor, or indeed at the outer edge of our solar system, customers are increasingly relying on ADI's product and applications know-how to help navigate the new intersection between the physical and the digital worlds. Just this past quarter, for example, ADI's mix signal processing capability was onboard the New Horizons deep space probe, providing critical measurements and conversion capability to the spacecraft as it navigated past the surface of Pluto.

In industrial applications, we see factory automation and control, or as some call it industrial IoT, as the next driver of industrial revitalization. Other industrial applications that fall within this umbrella include smart agriculture and smart cities. All these applications leverage our current product offerings, as we help our customers carve out new ways of using our technology, and in many ways, helping them unlock new sources of value in this emerging industrial IoT.

One of the areas that most excites me about the impacts of our innovation is in healthcare, where we have been investing for some time now. Here, our focus is on critical care imaging applications and clinical-grade vital signs monitoring. Today, ADI is working with several of the world's leading research institutions and systems OEMs to drive game-changing advancements in the performance, impact, and affordability of medical electronics devices, helping shift healthcare delivery to point of care and greatly improving the lives of countless patients.

In automotive, active, predictive, and passive safety systems, precision power train control systems, and high-quality multimedia systems require a proliferation of sensors and actuators, which in turn place ever-increasing demands on signal processing technologies, as do government mandates. These are an excellent match for our offerings. In addition, while we continue to have a strong position with US and European manufacturers, we still have opportunity ahead as we increasingly serve the Asian market.

The near-term volatility in communications infrastructure gives us no pause about the long-term upward trend in this market. The facts are that 4G penetration is low, data consumption is increasing exponentially, and radio density is also increasing. But in order for carriers to continue densifying their networks, our customers must solve the significant challenges associated with making the most efficient and flexible use of available spectrum, while at the same time reducing power and systems cost. ADI's software-defined radio and transceiver technologies help solve these very tough challenges, while also delivering a lower total cost of ownership to our customers, and in the process, driving growth for ADI.

In wireline infrastructure, we focus primarily around the timing and control of the signal path and optical communications systems, where the engineering challenge requires very high performance timing and precision processing. The move from 10 and 40G to 100G systems to satisfy burgeoning data demands further creates strong growth opportunities for ADI. Overall, our mixed-signal RF and microwave technologies are in increasing demand for many thousands of customers, and we are continuing to invest aggressively to capture the growing opportunity available to us.

So in summary, we remain committed to growing our revenues at 2 to 3 times GDP, to grow diluted earnings per share by 8% to 15% annually, and achieve our EPS goal of $4 to $5 by 2020. Finally, let me end by saying that the uncertainty in the macro environment is not due to any of us.

At ADI, we take a long-term view, and we believe that innovation is the cornerstone of business success. While we manage our investments conservatively, we execute our strategy aggressively. So we are confident that our ethos of innovation, our leadership in signal processing, and our alignment to favorable macro trends will allow us to outperform and continue delivering strong returns to our shareholders.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Great. Thank you, Vince. Thank you. Folks, during today's Q&A session, please limit yourself to one question. We're going to run the call until 6pm, so after you ask your primary question, please requeue if you'd like to ask a second question. And the reason we do this is we run our call in this format. The call, all the callers get a chance to participate on the call and get to ask at least of one of their questions. So we try to do it in the spirit of fairness here. So with that, operator, let's start the Q&A session.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Chris Danely, Citi.

Chris Danely - *Citigroup - Analyst*

Hey, thank you, guys. Just a question on the consumer end market, obviously some pretty strong performance this quarter and the previous quarter. For the January quarter, do you think consumer can continue to increase, and what would be the factors there?

Dave Zinsner - *Analog Devices, Inc. - CFO*

Good question, Chris. Typically the first quarter for consumer is seasonally down. So I think we would expect year-over-year it would be up. But my guess is sequentially it will be down, because that's typically what happens seasonally in that business as the Christmas season gets behind us.

Chris Danely - *Citigroup - Analyst*

Great. Do I get a follow-up?

Dave Zinsner - *Analog Devices, Inc. - CFO*

No, requeue.

Chris Danely - *Citigroup - Analyst*

All right. If you don't ask, you don't get it.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Thank you for the question, Chris. This is Ali here.

This is a good opportunity to remind folks on the line here about the ADI story and why we believe ADI offers investors what we believe is a pretty unique combination and a fairly balanced approach to all three things: revenue growth, operating leverage, and shareholder returns. So in terms of revenue growth, we believe we are tied to the right end markets with the right technologies and products. For example, about two-thirds of our sales are from industrial and automotive, and over two-thirds of our sales are from products and technologies where we in fact lead the market. So we believe that forms a pretty good, wide sustainable moat around our business.

Number two, in terms of operating leverage, as Dave mentioned in his prepared remarks, we've marched those up margins up about 500 basis points over the last several quarters. And we still have about 200 basis points of operating margin leverage remaining in our model.

Lastly, in terms of shareholder returns, as you all know, we've committed to returning 80% of our free cash flow to shareholders. We also have a target to increase our EPS by 8% to 15% annually. We have an EPS target of $4 to $5 per share, which when you look at the trailing 12-month number here, we've been in the $2.80 ZIP Code. So we believe that $4 to $5 EPS target is a meaningful one for investors.

So all said, we believe we've got a pretty good balance of revenue growth, leverage, and shareholder returns going. So thank you for the question, Chris. Feel free to requeue, and we'll get to our next question. Thank you.

Operator

John Pitzer, Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

Good afternoon, guys. Thank you for letting me ask the question. Dave, I want to get a little bit to the margin profile on the consumer business, both on the gross and the operating line.

I'm assuming that all of the gross margin decline in the October quarter is because of the increase in consumer. I'm just wondering it seems like consumer is up a lot in October, but not up as much as July. But the impact to gross margin sequentially is about the same. I'm just wondering if there's anything going on within consumer mix. And I guess more importantly, how do I think about operating margins in that consumer business, because clearly there's not as much SG&A expense to that incremental revenue.

So it has been dilutive to gross margin but accretive to op margin? Is that the way I should think about it? Thank you.

Dave Zinsner - *Analog Devices, Inc. - CFO*

There's a lot of puts and takes in both the second -- or the third and fourth quarter. Gross margins are a little bit dilutive in the consumer business, obviously, but it's relatively modest compared to the corporate average. But there are a whole lot of other businesses that are going up and down, and so collectively, I think mix was actually pretty flat for the third quarter. We think the fourth quarter probably mix will impact it a little bit negatively.

I think the gross margins really were down in the third quarter, mostly as a result of inventory reserves we took against some last time builds related to Hittite as we transition some of the production away from one country and into another foundry. The old parts we took a reserve on for the levels that were beyond I think about a year.

On the operating margin side, the consumer -- incremental consumer business is accretive. That's why we saw gross margin expansion this quarter. That's why we think midpoint of our guidance we'll see operating margin expansion in the fourth quarter as well.

So it's obviously we're leveraging a lot of existing technology that we've invested over the course of a decade probably to be able to serve the consumer business. And so as a result, the ongoing R&D expense isn't terribly significant.

John Pitzer - *Credit Suisse - Analyst*

That's helpful, Dave. Thank you and congratulations on the strong results.

Operator

Craig Ellis, B Riley.

Craig Ellis - *B. Riley & Co. - Analyst*

Thank you for taking the question, guys, and congratulations on the performance. The question is a follow-up to the two earlier with regards to the consumer segment.

Can you speak to the degree to which you're seeing application and customer breadth with the platform technology that's favorably impacting the third and fourth quarter's results? And from here, what's the opportunity to grow customers and application exposure as you look out to FY16?

Dave Zinsner - *Analog Devices, Inc. - CFO*

Precision technology, we're attempting to leverage that across all of our end markets and all of our customers. The specific product is -- that is driving some of the demand for next quarter is specific to one customer. And in a lot of cases, we work with those customers to customize the technology for their needs. And obviously as we do that, we don't give that to another customer to be able to utilize.

So I don't know if this answers your question, Craig, but our fundamental tenant is to take our technology and leverage it to as many customers as we possibly can and as many and markets as we possibly can.

Vincent Roche - *Analog Devices, Inc. - CEO*

Craig, we have a 40-year-plus heritage of developing silicon -- precision silicon, high-speed silicon. But the precision silicon is -- the industrial market is largely about control-type applications which is precision-oriented. So that's the primary market for that technology.

And as we -- you get different markets driving technology, different rates, and you get a ping-pong between one market and another. So there's good leverage from the industrial-type applications into consumer for that technology but also vice versa. So many, many thousands of customers, and we have -- the business there is largely about many thousands of customers, many thousands of products.

But in some cases, we customize products for markets and indeed customers. So it's a very, very complex diversified space.

Craig Ellis - *B. Riley & Co. - Analyst*

Thank you, guys.

Operator

Tore Svanberg, Stifel Nicolaus.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Yes, thank you. Great results. I'm going to ask a non-consumer question.

So some of your peers have talked about the slowdown here in the last couple of months in order rates, especially in the industrial market. I'm just wondering, what you're seeing? I do realize you're guiding for the industrial business to be fairly flat this quarter, but just from a macro level, what are you seeing on your order rates?

Dave Zinsner - *Analog Devices, Inc. - CFO*

I would say, so in general our order rates were pretty stable. They were stronger, obviously in the consumer business. They were a little softer in the industrial business.

But not atypical for this period of time, given that July and August are months in which a lot of industrial customers take the opportunity to shut down their production for some period of time. And so, we normally see a little bit of a softer patch in terms of order levels. But it was very typical relative to other third quarters. So we didn't really see anything anomalous in the order patterns that would suggest there's macro weakness out there or anything like that.

Ali Husain - *Analog Devices, Inc. - Director of IR*

The only thing I'd add to that, Tore, is when you look at generally some of the outlooks provided by some of the large distributors out there for their components business, they're generally operating in some level of -- some seasonal range. They may be operating at a lower end of that seasonal range, but I think for folks like ADI where we don't have a lot of PC exposure. In fact our PC exposure is probably nil, and we're levered to the kinds of markets, particularly in the industrial space for example, that do play in the -- fairly closely with some of the distributors are also exposed to, number one.

Number two, our revenue recognition policy is extremely conservative. We only recognize revenue and distributor sell-through, so we believe we're probably a little closer to end demand than maybe some of the other folks out there. And then lastly, our weeks of inventory in the channel are still at 7.5 weeks.

So our sense of it is that we're operating in some kind of a seasonal range here. The bottom hasn't dropped off, I'd say as maybe some of the competitors out there have maybe spoken about. But I think generally our sense is that what we're seeing is generally in line with probably what you've heard for some of the other distributors out there.

Tore Svanberg - *Stifel Nicolaus - Analyst*

That's helpful. Thank you very much.

Operator

Chris Caso, Susquehanna Financial.

Chris Caso - *Susquehanna Financial Group - Analyst*

Yes, thank you. Just a follow-up question with regard to the automotive market, and that was also a market that looked like it was a bit weaker than perhaps you had planned coming into the quarter.

Would you consider the order rates there also to be stable? Obviously, there's a lot of macro concerns in there. What are your customers telling you with regard to that market?

Dave Zinsner - *Analog Devices, Inc. - CFO*

At this point, that business is stable. The third quarter is generally a softer quarter again for the automotive space. Again, for the same reasons that the industrial business is generally sees some weakness in the summer months. Automotive guys tend to take some production downtime, particularly in July.

It was on the lower end of our normalized range that we would have expected, so it wasn't out of the norm. Maybe just a little bit weaker, and of course this is always tough to call with any form of certainty, but the order rates were stable in auto. My guess is they will be at least flat in terms of shipments next quarter, if not a little bit better. And so I think that business is behaving as we would expect.

Chris Caso - *Susquehanna Financial Group - Analyst*

Great. Thank you.

Operator

Vivek Arya, Bank of America.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you for taking my question. It's related to the automotive space.

When we look at the growth so far this year, it's been flattish. The question is, is this just tied to some specific customer patterns or is it lumpiness? Or do you think some other consolidation or M&A might be required to get growth rates up to what a lot of the peers are reporting?

Dave Zinsner - *Analog Devices, Inc. - CFO*

I think we have a really good pipeline of opportunities in that business, and Vince and I have spent the last several weeks really going through their pipeline with them. We're excited about really in every sub-segment within automotive and infotainment, in safety, in power train, the opportunities we see out there in the future for automotive.

Every so often you get a year where because of the way the models roll out and the timing of where our products get designed into those customers, sometimes you get a year that is a little softer. And that's made up usually by another year where things are very strong. One year, I think we grew 25% year-over-year; another year I think we grew 4%.

So this is pretty much in the norm. Our goal is to grow this business high singles, maybe even into the double-digit range over time. And we'll have certain years that do better than others, but if you look at the pipeline, we think we've got the opportunities to allow us to drive good growth in that business.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you and congratulations again on the execution.

Operator

Ralph Seymore, Deutsche Bank.

Ross Seymore - *Deutsche Bank - Analyst*

Hi guys. Can you go into a little more detail on what's going on in the comm side? We know that China was weak for others, and you split out the wireline versus the wireless side, but the confidence you have that you're under shipping demand and any guess as to when that might snap back?

Dave Zinsner - *Analog Devices, Inc. - CFO*

I think communications, as you know, has seen some weakness, particularly in China. Given what we think is a stoppage of rollout of macro base stations, while they do some investigations.

We think we've reached the bottom of what we might experience, and that it's unlikely to get any lower from here on the wireless space. But it's anybody's guess as to when that resumes.

We have gotten, and Vince can probably add more color to this, we have gotten input from our OEM customers that it will resume. And it's really just a question of when at this point.

Vincent Roche - *Analog Devices, Inc. - CEO*

I think David is right. At least the demand from the OEMs and ADI is stable. As Dave said, I believe we've hit the bottom. So I think let's say we're primed and ready to go in terms of supply line when the demand kicks back, which I believe will be much sooner than later here.

Ross Seymore - *Deutsche Bank - Analyst*

Great. Thank you.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Thank you, Ross. The only thing I'd add to that is the bookings are, as we just mentioned in the prepared remarks, the bookings are stable, which is always a good sign in this business.

And we did go back and look to see when the last time we were at these kind of revenue levels in the comms infrastructure space and it's been a long time. So it's very, very low, and our sense is that things are at least stable here. And if you can call a recovery on it, let me know, but it's always harder for us to do it. So, thank you for the question. We'll get to our next caller.

Operator

Blayne Curtis, Barclays.

Blayne Curtis - *Barclays Capital - Analyst*

Hey, thank you for taking my question, and I'll offer my congratulations as well. Dave, I was just curious, you came at the high-end of the range. The other segments are weak, so consumer was up even more.

To the extent you can talk about it, I know it's hard, what drove that upside? Was it more timing? Maybe the ramp happened earlier or was it just the sheer volume?

And then as you look to October, the wider range than usual, particularly given it looks like it's mostly consumer. Can you talk about what the puts and takes there are as well? Is there other products or is it just you're being -- taking a more conservative angle on the ramp? Any help there? Thank you.

Dave Zinsner - *Analog Devices, Inc. - CFO*

Sure. Thank you, Blayne.

So the third quarter did come in within the range. Clearly, it was at the high end of the range, so we did have a scenario in which we were going to get to this level. It doesn't come as a complete surprise. I would say that that was our best case scenario, and that actually played out.

And obviously that had a lot to do with the consumer business and the fact that these ramps can be dynamic in terms of how the production gets rolled out and you get input from the customers. But that is changing week to week and you never know really how you're going to -- how things are going to progress. And so we take a couple of different scenarios that might occur, and it just so happens that this one ended up being the more positive outcome.

We again do that for the fourth quarter, and that is why we have a wider range. There's obviously a scenario in which the production ramps fast and stays stable within the quarter. There's a scenario, obviously in which it ramps up, but then they get to their inventory levels that they need and things pause for a little bit.

So we hope that we've been conservative enough in our forecast to make sure that we stay within this range. And I think we have tortured this quite a bit, as you might imagine, and we feel pretty confident that we've got the right range in there.

Blayne Curtis - *Barclays Capital - Analyst*

Perfect. Thank you.

Operator

Ambrish Srivastava, BMO Capital Markets.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Hello. I'm on the road. Just wanted to make sure I can be heard.

A question on the overall business mix. What is the right way to think about longer term, the business would look like? Clearly consumer is doing great for you, but as you all know, the investor base is also attractive to the balanced -- Ali, as you were pointing out, the balanced business model. No real concentration to a customer.

So longer term, what's the right way to think about -- what is the mix that will make you folks feel comfortable, okay, this is how the business should look like? Thank you.

Vincent Roche - *Analog Devices, Inc. - CEO*

Well the strategy is playing out as we've designed it. We have, let's say over the last five or six years, been steering more and more of our R&D towards what we consider to be business-to-business applications like industrial, healthcare, automotive, and communications infrastructure. That's where the lion's share of our R&D is placed, and that's where the lion's share of our sales force works as well to ensure that we cover the -- that we grab the opportunity by covering the broadest base of customers and applications that we can.

We've always said in the consumer area that we have a very, very targeted, focused play in terms of R&D and customer engagement. And that we play only in spaces where technology makes a huge difference to the user experience and where the technology we believe is sustainable over time. So clearly, the consumer markets are more volatile than, let's say, the B2B markets.

But we've got a good blend, I think as a Company in terms of being able to invest in the areas that give us the longer product life cycles, the more sustainable businesses, and I think a good fit and a very sustainable investment in the consumer space. So over time, as demand moves between one sector or the other, B2B versus consumer, so will go the fortunes of the business.

But I think overall, what you've got to look at is the commitment that we've got to delivering 2 to 3 times GDP, gross margins in the 65% to 68% range, and getting our EPS well above $4. So that's our goal, that's our mission, and that's what we're delivering.

Ambrish Srivastava - *BMO Capital Markets - Analyst*

Thank you.

Operator

Steve Smigie, Raymond James.

Steve Smigie - *Raymond James & Associates, Inc. - Analyst*

Great, thanks a lot guys. I was hoping you could talk a little bit more about China, and specifically, can you talk about if industrial orders for China were any different from other regions?

And as you look more longer term, obviously, there's been a lot of talk in the news about does China shift to a different economy where they're not just the manufacturing hub of the world and invest more in the service economy, et cetera. So does that suggest to you that maybe there's some lower opportunity for industrial growth for you guys into the future?

Vincent Roche - *Analog Devices, Inc. - CEO*

It's a very good question. So clearly, as you said, China is shifting from -- we make it to -- we design it and build it. So we've benefited -- this will be actually, when history is written on our FY15 here, we will have had -- we will have posted very, very strong double-digit growth in the industrial sector in China. Across the board, in fact in healthcare, in energy, transmission and distribution of energy, in particular, and also industrial instrumentation and automation.

So clearly, China is in the process of indiginizating -- indigenizing the tech industry there. So we're benefiting from that in terms of our engagements with emerging OEMs in -- way outside of the consumer -- the communications infrastructure and consumer businesses. So industrial is emerging, automotive is emerging, healthcare is emerging, and we're doing particularly well. I'm pleased with the progress we're making in building out our business there.

Steve Smigie - *Raymond James & Associates, Inc. - Analyst*

Great. Thank you. The part about the short- term on China versus other regions in industrial?

Vincent Roche - *Analog Devices, Inc. - CEO*

It's been very, very -- it's been quite strong, and it remains steady.

Steve Smigie - *Raymond James & Associates, Inc. - Analyst*

Great. Thank you.

Operator

Romit Shah, Nomura.

Romit Shah - *Nomura Securities Co., Ltd. - Analyst*

Yes, thank you and congratulations on what looks like a very solid FY15.

Vince, ADI has this history of being in and out of the consumer market. If I look at the October quarter, it looks like consumer will be roughly 30% of sales. And my guess is that portable will account for a substantial portion of that. So my question is what's your confidence or visibility into sustaining your position here in this high-volume program?

Vincent Roche - *Analog Devices, Inc. - CEO*

We have, in the past, I think in many cases, we have -- at one point in time about five or six years ago, we were spending about 35% or 40% of the entire R&D budget of the Company in many, many different applications within consumer.

I think the way to think about this time, the spend is quite constrained. It is in an area that is very, very close to the core capability of the Company, and we're playing with market leaders. We're playing with the leaders and defining really exciting opportunities together that we think have really got legs over the long term.

So it's a very focused engagement and we are really concentrating on uncovering those problems that give us the opportunity to apply the best of our technology over the long term. I think that's how to think about it.

Romit Shah - *Nomura Securities Co., Ltd. - Analyst*

I guess my question is, how do you manage the risk associated with mix, given that consumer is now a larger percentage of sales than I think we've seen in the last 5 years, 10 years?

Vincent Roche - *Analog Devices, Inc. - CEO*

The foundation of this Company is the business-to-business space. It's the communications infrastructure. It's the industrial business, automotive, healthcare, where we have many, many thousands of customers, hundreds and hundreds of applications, 20,000 products used, and the R&D is largely pointed there. So that is the core business of ADI and will remain so into the future.

So in terms of how -- I'm telling you how we're strategically viewing it. How demand patterns evolve over time will depend on macro markets, will depend on the success of our technology and so on and so forth. But I think we've got the right strategic mix here, and the rest is down to how well we executed in the markets.

Romit Shah - *Nomura Securities Co., Ltd. - Analyst*

Okay. Thank you.

Operator

Stacy Rasgon, Bernstein Research.

Stacy Rasgon - *Bernstein - Analyst*

Hi guys. Thank you for taking my question.

Do you think your -- what would your book-to-bill be if you took out the consumer ramp? I know you said it's positive right now. What would it be if you took the consumer ramp for next quarter out?

Dave Zinsner - *Analog Devices, Inc. - CFO*

I think it's, yes, roughly 1.

Stacy Rasgon - *Bernstein - Analyst*

Roughly 1? Even with industrial following in automotive? I know you said it was sort of in line, but it was mostly flat, it was down 7?

Dave Zinsner - *Analog Devices, Inc. - CFO*

Yes.

Stacy Rasgon - *Bernstein - Analyst*

Okay. Thank you, guys.

Dave Zinsner - *Analog Devices, Inc. - CFO*

Thank you.

Operator

Craig Hettenbach, Morgan Stanley.

Craig Hettenbach - *Morgan Stanley - Analyst*

Thank you. Just a question on Hittite. Just a couple quarters in now, just how the integration's going? And then just bigger picture, as you think about capital allocation and your appetite for M&A versus buybacks and dividends?

Dave Zinsner - *Analog Devices, Inc. - CFO*

The Hittite integration is going fantastic. The business has done great, and we are exactly on plan in terms of our synergies.

And really, I'm interested to hear Vince's take, but I would say it's almost as if that whole prior Hittite aspect of the Company has completely gone away. They're part of the ADI family. They operate -- in a lot of ways, you can't tell the ADI employees from the Hittite employees in the RF space -- or RF part of our business. So it's been a tremendous success.

Our intended use of capital does include acquisitions going forward, and we continue to look at different opportunities in that space. As you know, we're looking for technology that is highly differentiated, that's really synergistic with what we're doing with our customers, where our customers will see value in us having that capability or where we think that will integrate with some of the things we do in a way that just elegantly provides a solution to the customer. And so, we continually monitor what opportunities are out there.

I wouldn't guarantee that we're going to do an acquisition in the next year. But I think it's a reasonable probability that there will be some tuck-in kind of opportunity for us over the next year that could be just as dynamic as Hittite was for the ADI business.

Vincent Roche - *Analog Devices, Inc. - CEO*

I think just to add a little bit of color to what Dave has said, in terms of Hittite, we were always very, very confident in the technology, the market position of Hittite. So really, if there was a risk, it was going to be around the cultural integration of the two entities. So we share very simple -- we knew that the value system at Hittite was very, very similar to ADI's in terms of the belief that innovation drives business success. That engineering excellence is really what matters in that business to customers.

That's exactly how it's played out, and I think when you watch, as I do, the interaction of our engineering teams with our biggest customers out there and across the board, in many, many different applications, not just in communications but the leveraging of that technology into areas like aerospace and defense instrumentation, satellite communications, it's really tremendous. So I have enormous optimism and confidence about the combination of the RF and microwave talent across the entire Company and what it means for the future growth prospects of ADI. So great, delighted with it.

Craig Hettenbach - *Morgan Stanley - Analyst*

Got it. T hank you.

Operator

William Stein, SunTrust.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Great. Thank you for taking my question.

I'm wondering if you can dig a little bit more into the wireless part of the business. Understanding that we're seeing a pause in China and the business is down quite a bit from its prior peak. I'm wondering what gives you confidence that we're at the bottom and that you see a snapback in relatively short order? Thank you.

Dave Zinsner - *Analog Devices, Inc. - CFO*

I think it's two reasons. One, the order rates have stabilized over a fairly long period of time, and usually when things are weakening, you see it in the order rates pretty quickly.

And then the other thing is, Vince and some of the business unit leaders, they're regularly going out to the larger OEMs that supply into this space, our customers, to get a pulse of what's going on. And the feedback from those customers is that they have obviously reduced their order flow to us, to this level for reasons that we're all aware of well aware of. But their expectation is that they are going to turn those order levels back up at some point within the next couple of quarters.

So we don't know exactly when that will happen. It could happen in the late part of next quarter. It could be first-quarter before it happens, but given that the OEMs are telegraphing that to us, that gives us some confidence that we're at the bottom, and that in all likelihood, we'll see it turn back up at some point here.

William Stein - *SunTrust Robinson Humphrey - Analyst*

Great. Thank you, and congratulations on the quarter.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you.

Operator

Amit Daryanani, RBC Capital Markets.

Amit Daryanani - *RBC Capital Markets - Analyst*

Thanks a lot. Good afternoon, guys.

I guess a question on your free cash flow conversion numbers. It was around 19% this quarter as a percent of sales. Last four quarters, it's been around 25% I think. What do you think it takes it to get within your target of 28% to 32%, and as consumer gets bigger, does that have any impact free cash flow generation as you go forward?

Dave Zinsner - *Analog Devices, Inc. - CFO*

Well, that's a good question. I think really when you look at this quarter, because of the ramp in the consumer business, that requires us to lay out a fair amount of cash to our foundries to build up the inventory to be able to support that demand. And so our working capital number, I think if you looked at it relative to the past several quarters, you'll see it's actually quite a bit more negative than in most quarters. I think that's part of it.

We were in the trailing edges of spending a bit on building infrastructures. That's mostly behind us now, and so I think that starts to improve.

And then lastly, we pay our variable compensation every other quarter. It just so happened to be this quarter we paid out a half a year's worth of variable compensation, and so that hit us as well.

So this was like the perfect storm of all the things going against us on a free cash flow basis. But we've analyzed this quite a bit, particularly recently, given that the number was a little bit below our benchmark. And we feel pretty confident that we will be within that range in relatively short order, once we get to a normalized state in terms of working capital, in particular, related to the consumer business.

Amit Daryanani - *RBC Capital Markets - Analyst*

Perfect. Thank you and congratulations on the quarter.

Operator

CJ Muse, Evercore ISI.

C.J. Muse - *Evercore ISI - Analyst*

Good afternoon. Thank you for taking my question.

Curious in terms of the macro demand picture and whether or not you're seeing any softness geographically? So that I guess primarily a question around auto, industrial and what you can share there cycle-wise and demand-wise? And then if I could sneak a second one in, did you have a 10% customer in the quarter? Thank you.

Vincent Roche - *Analog Devices, Inc. - CEO*

Let me talk about the geo thing a little bit. I think overall, just to give you a little bit of color there, so Europe I would say, not surprisingly, the industrial sector is a little weak. Europe tends to take a pause. And I'd say the industrial sector in particular was maybe a little weaker than we had expected.

So I think as well, North America and industrial was also relatively weak; some sectors were better than others. And I think when you look at China and Asia Pacific, automotive was quite soft. And it's well-publicized that the communications infrastructure was weak, but at least the pattern was stabilized there.

Dave Zinsner - *Analog Devices, Inc. - CFO*

And then in response to the 10% customer, we did have one customer for the quarter that was greater than 10%.

Vincent Roche - *Analog Devices, Inc. - CEO*

Thank you, CJ. I think that was two questions, so.

Dave Zinsner - *Analog Devices, Inc. - CFO*

No re-queuing for you. You violated the rule.

Operator

Ian Ing, MKM Partners.

Ian Ing - *MKM Partners - Analyst*

Thank you for taking my question. How close to full factory utilization are you in the October quarter?

And with the consumer mix, has your view changed on managing factory utilization and internal inventory throughout the year? Is it possible to get steadier utilization throughout a normal year?

Dave Zinsner - *Analog Devices, Inc. - CFO*

We were in the mid-70s for utilization this quarter. That was similar to where we were last quarter. I don't remember if I said it before, but we are probably going to take utilization down a little bit in the fourth-quarter.

All of the ramp in revenue for the fourth-quarter, at least on a front end -- from a front-end perspective, will come from foundries. So it won't affect utilization in any way on the front end.

Ian Ing - *MKM Partners - Analyst*

Thank you.

Dave Zinsner - *Analog Devices, Inc. - CFO*

Sure. Now ideally, over time, we're working to get that utilization up, and it has been I think if you look at it on a year-over-year basis, it has been steadily moving up a little bit and it has been helpful to gross margins. So that is our goal, to make better use of our existing factories to drive gross margin expansion.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Next question?

Operator

Jim Covello, Goldman Sachs.

Jim Covello - *Goldman Sachs - Analyst*

Hey guys. Thank you for taking the question. Congratulations on the terrific results.

A philosophical question going forward, I wondered what your approach will be for folks who have won a lot of consumer business or ramped a lot of consumer business, in particular with one big customer over time some of your analog peers, someone like [a Linear]. When that product comes up for invariable price declines or ASP declines, some analog companies have walked away from that business like Linear.

Others like in NXP have said look, as long as we're maximizing gross profit dollars, we don't care if it hurts our gross margin a little bit. Either -- obviously, either approach is fine; both companies have been incredibly successful with those different approaches. But I wonder what your philosophy will be on that as we go forward?

Dave Zinsner - *Analog Devices, Inc. - CFO*

Our goal is we won this business; our goal is to keep it. And the good news is we think it's technology that has a lot of legs to it, that is highly differentiated, and as a result, the customer values it and pays a premium for it. So we're not -- our anticipation is that we will not lose it nor will we have massive ASP erosion as a result, but that will be borne out over time.

Vincent Roche - *Analog Devices, Inc. - CEO*

Look, I think another aspect of the strategy here is that a lot of technology trends center around these types of consumer systems being able to see, being able to hear, being able to feel. And I think there's some great macro trends there that speak very well to the types of technology that we have, the intersection of the physical world, and the world of the digital.

So as the performance goes up, the space is getting tighter and tighter. Battery-powered efficiency has got to become greater and greater. There's some really chunky problems to be solved there.

So and not just one type of problem; there's many, many different problems. So we seek, as we do across all our businesses, we look for diversity in each application in terms of the types of technology that we can apply, the number of products that we can develop. And so it's not a tale of one product, one customer. It's a tale of many, many different types of technologies across many, many different modalities there in terms of intersection of the physical and digital worlds.

Operator

Tore Svanberg, Stifel.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Coming back to the seasonality part of the business with consumer being about 30% in the next quarter, how should we think about not just the January quarter, but maybe even the April quarter? So you've had some seasonality in the past. I'm just trying to figure out how that's going to play out going forward.

Dave Zinsner - *Analog Devices, Inc. - CFO*

Tore, you're asking me to whip out the crystal ball here, which I don't know, it might be on the fritz.

I would say that sitting here today with almost no backlog to really tell for certain how things are going to progress, that the first quarter, which is typically down mid-single digits, given that there's a more significant percentage is likely to be in the consumer space in the fourth-quarter, and that that has normally a more dramatic seasonal decline in the first quarter. We're likely to be more than mid-single digits down sequentially in the first quarter, but I'm not certain of that.

And then in the second quarter, generally consumer seasonally is relatively flat first quarter to second quarter, but we have this lift in industrial, this tends to be our best quarter for industrial in the second quarter. And that gives us a good lift for the second quarter sequentially. And so, that is how I would model it out right now, having limited information as to how things behave.

Tore Svanberg - *Stifel Nicolaus - Analyst*

Very helpful. Thank you, Dave.

Operator

John Pitzer, Credit Suisse.

John Pitzer - *Credit Suisse - Analyst*

I have a follow-up. Dave, just real quickly, when you look at the October run rate on the consumer side, does that now represent your full opportunity on the mobile side, i.e, multiple platforms at a certain customer? Or -- and hence from here, it's more of a unit story or actually potentially other platforms that you guys can penetrate within the consumer space?

Vincent Roche - *Analog Devices, Inc. - CEO*

I don't think I would suggest that the back half of the year we're ever going to have any specific additional platforms, but our goal over time is to expand in every end market in terms of opportunity. So over time, I think there is an opportunity to do that.

John Pitzer - *Credit Suisse - Analyst*

Thank you.

Operator

Vivek Arya, Bank of America.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you for letting me ask a follow-up and sorry to beat this dead horse about macro and seasonality. But is there something that is Company-specific outside of consumer that you think is helping you provide a more stable/seasonal outlook versus a more cautious outlook that we have heard from say Linear Tech or Microchip or Texas Instruments?

Dave Zinsner - *Analog Devices, Inc. - CFO*

I do think that the industrial business for us is made up of these broader market end markets and then these more ASSP-oriented markets. And I think it's safe to say that the broader markets were a bit weaker and that the ASSP or vertical markets did a little bit better.

And I think somewhere in Vince's remarks, he talked a lot about diversity. I think also Ali talked about it as well. That's the benefit of diversity, is we're in so many different parts of the industrial space, both the broad market and very interesting verticals and some do better than others and depending on the quarter.

But I think that really, if I had to line our performance up in the third quarter relative to what I saw from some of the other players, I would say where we outperformed seemed to be in some of the specific verticals like aerospace and defense and energy and so forth.

Vincent Roche - *Analog Devices, Inc. - CEO*

As you know, we are on a sell-through basis across the globe as well, so the transparency that we have around demand and supply is very, very strong. So our sense is that there's a good balance between consumption and supply at this point in time. And we, as a Company, measure only end-customer bookings, because that's what we base our understanding of demand on. And so what we're reflecting to you is what we see.

Vivek Arya - *BofA Merrill Lynch - Analyst*

Thank you. Very helpful.

Ali Husain - *Analog Devices, Inc. - Director of IR*

Great. Well, looks like we have reached the 6:00 hour here, and we appreciate everybody dialing in.

So listen, as a reminder, our 4Q 2015 results are planned to be issued on November 24, 2015 at 8:00 AM Eastern time. And our conference call should begin two hours later at 10:00 AM Eastern time.

So thank you again, everyone, for joining us this evening. We look forward to speaking with you again on November 24 at 10:00 AM. So good night.

Operator

This concludes today's Analog Devices conference call. You may now disconnect.